BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CENTRAL INDUSTRIAL LOAN COMPANY)

Appearances:

For Appellant: Huntington P. Bledsoe, Attorney at Law.

For Respondent: James J. Arditto, Acting Assistant Franchise Tax Commissioner; Crawford H. Thomas and Irving Perluss, Assistant Tax Counsels.

OPINION

These appeals are made pursuant to Section 25 and 27 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of the Central Industrial Loan Company to a proposed assessment of an additional tax in the amount of $351.38 and in denying the claims for refund of said company in the amount of $639.98, respectively, for the taxable year ended December 31, 1941.

The Appellant engaged in business in California during the years 1940 and 1941 as an industrial loan company. It imposed a fee or "service charge" in addition to the regular interest rate in connection with its loans and upon renewal an additional service charge was imposed. During the year 1940, the amounts of the so-called service charges were recorded on its books of account as income, and it was on this basis that the Appellant, in February 1941, made its return to the Commissioner. The Appellant keeps its accounts and reports its income on the accrual basis.

On or about March 1, 1941, the Attorney General of the State of California, at the instance of the Commissioner of Corporations filed an action against the Appellant, alleging that it was violating the law by charging excessive interest rates. A consent decree rendered in this proceeding provided that the service charges paid on the renewal of loans should be credited on the principal of the outstanding loans. Thereafter, on June 6, 1941, the Appellant filed an amended return for the year 1940, in which the amount of the service charges affected by the decree was excluded from gross income. As a result of this treatment of the service charges, the amended return showed a substantial net loss for the year 1940. The Appellant's claim for refund is based on

the contention that by reason of this loss it is liable only for the minimum tax for the year 1941.

The proposed assessment is the result of certain adjustments to net income made by the Commissioner. The Appellant does not contest the propriety of these adjustments, but if it is correct in its contention that the service charges credited on the principal of its loans did not constitute grass income for the year 1940, its business will have been conducted at a loss even after allowance is made for these adjustments. The only question presented by the appeal, therefore, is whether the service charges are to be regarded as a part of the Appellant's gross income for 1940.

On this point the position of the Commissioner appears to be that since the Appellant during 1940 claimed the right to collect the service charges, in addition to the principal and interest, and treated the amount of the charges as income, they must be treated as income for the purpose of computing its liability under the Act. In support of his position he cites the rule laid down in North American Oil v. Burnet, 286 U. S. 417, 424, that

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though... he may still be adjudged liable to restore its equivalent!'.

In the North American case a receiver was appointed in 1916 to operate the company's property and to hold the net income. In 1917 the District Court entered a final decree dismissing the bill, and thereupon the receiver paid over to the company the moneys in his hands. The actual decision was that the amount paid by the receiver was income of the company for 1917 rather than 1916, even though it represented profits from 1916 operations The statement quoted above was made by the Court in explaining why the profits were not income of the year 1922, when the litigation was finally terminated by the dismissal of the appeal taken from the District Court's decree, Although previously in the opinion the Court had stated that it was immaterial whether the company's return was filed on the cash or on the accrual basis, this was said with particular reference to the question of whether the income was taxable to the company in 1916 or 1917.

The Commissioner has cited several other cases arising under the Federal'income tax statutes in which certain amounts received by the taxpayer were held to constitute income even though there was no legal right to retain the money. Penn v. Robertson, 115 Fed. (2d) 167; Kurrle v. Helvering, 126 Fed. (2d) 723; Commonwealth Investment Co., 44 B. T. A. 445. In none of these cases, however, does it appear that the taxpayer was on the accrual

basis, and we do not, therefore, consider them controlling in the situation presented herein. When a taxpayer keeps his accounts and reports his income by the accrual method, as distinguished from the method of cashreceipts and disbursements, it is the right to receive income, rather than the actual receipt that determines the inclusion of the amount in gross income. Spring City Foundry Co. v. Commissioner, 292 U. S. 182; United States v. Utah-Idaho Sugar Co., 96 Fed. (2d) 756, cert. den. 305 U. S. 631.

Since the Appellant did not have any right to impose the service charges, and was required in the following year to make restitution by crediting them against principal, we believe that the amended return, in which the service charges were excluded from gross income, rather than the original return filed by it for the year 1940, properly reflected its income for that year. The computation of income in accordance with a judicial determination of the rights of the taxpayer rendered subsequent to the close of the taxable year is sanctioned by the decisions in Freuler v. Helvering, 291 U. S. 35, and De Brabant v. Commissioner, 90 Fed. (2d) 433. It has also been held that the action of a taxpayer in erroneously accruing on its books of account, as interest income, an amount which it is not entitled to receive does not justify the imposition of the tax on that amount. Commissioner v. Western Power Corp., 94 Fed. (2d) 563.

The Commissioner has cited Barker v. Magruder, 95 F. (2d) 122, involving a situation wherein the taxpayer had accrued on its books usurious interest which under local law was not legally collectible. On the ground that at the time of the accrual there was a reasonable expectation that the interest would be paid, it was held that the lender was required to pay income tax thereon. In our opinion this case is not consistent with the fundamental principal underlying the accrual system of reporting, as set forth in the authorities cited above. We do not, accordingly, regard it as controlling in the instant case, where there has been a judicial determination that the amounts were not legally due and restitution has been enforced.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the actions of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of the Central Industrial Loan Company to a proposed assessment of additional tax in the amount of $351.38 and in denying the claims for refund of said company in the amount of $639.98 for the taxable year ended December 31, 1941, pursuant to Chapter 13, Statutes of 1929, as amended, be and the same are hereby reversed. Said rulings are hereby set aside and the said Commissioner is hereby directed to refund to said Central Industrial

Loan Company the amount of tax overpaid by it for the taxable year ended December 31, 1941, the amount of the overpayment to be determined by the exclusion from the gross income of said company of the amount of the service charges paid to it on the renewal of its loans and the acceptance of the adjustments to net income, to any extent to which such adjustments may be material in the computation of net income, made in the Commissioner's proposed assessment of additional tax.

Done at Sacramento, California, this 2nd day of December, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
George R. Reilly, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierce, Secretary